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Appeal of Elsinore Naval and Military School

The issue presented in this appeal is whether appellant has shown that a worthless debt deduction in the amount of \$109,742 is proper for the income year ended July 31, 1978.

Appellant was incorporated as a military school in 1933. Due to its increased operational expenses, it established a nonprofit educational organization called Lake Elsinore Military Academy {hereinafter referred to as "Academy"). Academy had essentially the same board of directors as appellant.

It was planned that certain land, buildings, and equipment would be **conveyed** from appellant to Academy. To effectuate this plan, on February 18, 1971, appellant sold to Academy certain real property for \$500,000 and certain personal property for \$250,000. The sale of the real property was documented by a promissory note which was secured by a deed of trust. The \$500,000 note provided for ten annual interest payments of \$22,500 each. After ten years, the entire principal balance was due together with the interest which was calculated at 4.5% a year. The note for \$250,000 provided for a 4% annual **interest rate**, and after ten years both the principal and the interest were to be paid in full. We note that appellant has stated that no portion of the bad debt deduction at issue in this appeal was taken for the \$250,000 note for this **personal** property.

After Academy began its operations it encountered financial hardship. Beginning in 1971 and continuing through 1974, appellant advanced additional funds to Academy to help cover operational expenses. In 1974, an independent group of investors, headed by Mr. George Flowers, wanted to buy Academy and take **over** its operations. Appellant agreed to sell Academy for \$585,000 and an escrow was opened. In addition to the \$585,000 purchase price, appellant also wanted a note for \$100,000 to secure the funds already advanced to Academy to cover its operational expenses. At that time appellant allegedly thought it had advanced about \$95,000 to Academy, so a note for \$100,000 was deemed to be adequate. Appellant alleges, however, that this estimate was low and that approximately \$109,000 had been advanced. This debt was documented in a promissory note issued on May 22, 1974. The \$100,000 note was due in thirty days; **however**, if not paid at this date, interest was to accrue at 7% annual interest. The note was secured by a second deed of trust on the same real property that secured the \$500,000 note.

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The sale by appellant to the group of investors did not take place as the group was unable to raise the necessary funds, Academy, therefore, remained in an unstable financial state.

Because no payments were made by Academy on any of the above-referenced notes, on May 9, 1978, appellant foreclosed on the \$100,000 second deed of trust. Thereafter, for the income year ended July 31, 1978, appellant claimed a \$109,742 bad debt deduction based on this foreclosure.

Respondent subsequently disallowed the bad debt deduction and issued a proposed assessment. At the protest level, respondent examined the available records and concluded that no bad debt existed for the income year ended July 31, 1978, as the 1971 receivable was converted to a secured note which was subsequently collected upon by the repossession of the property securing it. Respondent's position on appeal is that Revenue and Taxation Code section 18103, subdivision (a), applies to the reacquisition of the real property which secured both the \$100,000 note and the \$500,000 note. This statute provides that no gain or loss shall be recognized to the seller upon reacquisition. Respondent asserts that the proper time to take a gain or a loss on this property is at a later date when the property, with its adjusted basis, is sold. As of this date, appellant still owns the property.

Appellant contends that Academy's total outstanding obligation to it at the time it foreclosed on the property was \$1,060,000 while the property had a value of \$800,000 or less. Appellant arrived at the \$1,060,000 figure by totalling the \$500,000 note, the \$250,000 note, \$210,000 in interest, and the \$100,000 note. We do not know the precise method by which appellant arrived at the amount of the bad debt. The difference between the alleged debt (\$1,060,000) and the alleged fair market value of the reacquired property (\$800,000) cannot be reconciled to the claimed bad debt deduction of \$109,742. We assume that the \$109,742 figure is equal to the amount appellant determined it actually advanced to Academy during the period 1971 to 1974 and which was secured by the \$100,000 note and deed of trust.

Revenue and Taxation Code section 18103 provides that, if a sale of real property gives rise to an indebtedness to the seller which is secured by the real property sold and the seller reacquires the property in partial or full satisfaction of this indebtedness, then, subject to

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certain exceptions not applicable in this case, no gain or loss will result and no debt shall-become worthless as a result of the reacquisition.

In this appeal,. appellant sold the real property to Academy in 1971 and received a \$500,000 note for the purchase price which was secured by the real property. This same real property was subsequently used to secure a \$100,000 note. Quite clearly, the provisions of Revenue and Taxation Code section 18103 apply to the \$500,000 debt. When appellant reacquired the real property in 1978 through foreclosure proceedings, the note emerged with a zero basis. The first question to be addressed is whether the same analysis applies to the \$100,000 note which was subsequently secured by the same property. If the \$100,000 deed of trust merges with the \$500,000 deed of trust, section 18103 will apply to both.

It is well established that the various estates **that**, may exist in real property may be created by deed. (15 Cal.Jur.2d, Deeds, § 10, p. 405.) In this case, appellant executed two deeds of trust. In both **cases**, Academy was the **trustor**, appellant was the beneficiary, and Security Title Insurance Company was the trustee. The \$100,000 **deed** of trust was a second trust deed.

A merger of estates will occur when a greater estate **and** a lesser estate coincide in the same person in one and the same right without any intermediate estate. (Shaw v. McCardle, 92 Cal.App.2d 616, 618 [207 P.2d 6451 (1949)]. The lesser estate is said to be annihilated or merged into the greater. (Wilson v. Kipp, 94 Cal.App.2d 426, 429 [210 P.2d 9081 (1949)].) In the case of Union Bank v. Wendland, 54 Cal.App.3d 393 [126 Cal.Rptr. 5491 (1976)], the court considered whether a note secured by a first deed of trust and 'a **subsequent** note secured by a second deed of trust, both involving the same parties and the same real estate, could be merged into one estate. They concluded that the second deed of trust, the lesser estate, merged into the first deed of trust, the greater estate, because the same parties had commensurate and coextensive interests with no intervening interest. The same analysis applies to the present appeal. There was clearly a relationship between the loans. The first loan was involved in the purchase of the property and the second loan involved the money necessary to keep the property in operation. It is inescapable that the parties intended the same real estate **to** be the security for the original note and for the subsequent \$100,000 note which was foreclosed upon. Deeds of trust were executed for both, making the real estate the

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security for the first note and the \$100,000 note. As the \$100,000 deed of trust was merged with the \$500,000 deed of **trust**, the provisions of Revenue and Taxation Code section 18103 will apply and no loss will result. This finding is consistent with section 1038 of the Internal Revenue Code, which is substantially the same as section 18,103 of the Revenue and Taxation Code, and Treasury regulation section 1.1038-2, subsection (f)(1), which provides that:

No debt of the purchaser to the seller which was secured by the reacquired real property **shall be** considered as becoming worthless or partially worthless as a result of a **reacqui-**
sition of such real property to which this section applies. **Accordingly**, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real
p r o p e r t y .

Finally, we conclude that, even if there were no merger of the deeds of trust, no deduction could be allowed. Revenue and Taxation Code section 17207 and its counterpart, section 166 of the Internal Revenue Code, allow a deduction only if the debt becomes worthless within the **taxable** year. Appellant bears the burden of establishing that the debt in question actually became worthless during the income year ended July 31, 1978. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976.) To satisfy this burden, appellant must show that the alleged debt had value at the beginning of the taxable year and that some identifiable event occurred which formed a reasonable basis for abandoning any hope that the debt would be paid sometime in the future. (W. A. Dallmeyer, 14 T.C. 1282 (1950).) As no evidence has been submitted to satisfy this statutory requirement, the action of respondent must be sustained.

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